of hardware reference platforms, and fulfillment and distribution services, we expect to enable our partners to achieve rapid time-to-market while minimizing their customer support costs.

Critical Accounting Policies And Estimates

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates and judgments, including those related to: revenue recognition; product warranty obligations; allowance for doubtful accounts; inventory valuation; goodwill, intangible assets and long-lived assets; acquisition accounting; restructuring and other charges; stock compensation expense; and income tax asset valuation. We base our estimates and judgments on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form

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the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition

We generally recognize revenue from sales of our products upon shipment to customers provided persuasive evidence of the arrangement has been received, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, title and risk of loss have passed to the customer, and all other revenue recognition criteria of SEC Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" are met. At the time of a sale transaction, we make an assessment of the collectibility of the amount due from the customer. Revenue is only recognized at that time if we are reasonably assured that collection will occur. In making this assessment, management considers customer creditworthiness and historical payment experience. Our server appliance customers are not granted rights to return our products after the purchase has been made. However, in certain circumstances, we have accepted returns, although we were not contractually obligated to do so. Our distribution customers are offered a thirty day right of return. We record a provision for potential returns based on our historical return rate. Material differences may result in the amount and timing of our revenue for any period if management makes judgments or uses estimates that prove to be materially different from actual experiences.

Product Warranty Obligations

We offer a warranty on all of our products that generally provide for us to repair or replace any defective products for a period of up to 36 months after shipment. Based upon historical experience and expectation of future conditions,

we reserve for the estimated costs to fulfill customer warranty obligations upon the recognition of the related revenue. Significant judgment and estimates are involved in estimating our warranty reserve. To the extent we may experience increased warranty claim activity, increased costs associated with servicing those claims, or use estimates that prove to be materially different from actual claims, our warranty reserve may need to be increased, resulting in decreased gross profits.

Allowance for Doubtful Accounts

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and each customer's current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain an allowance for doubtful accounts based upon historical experience and any specifically identified customer collection issues. In addition, when evaluating the overall adequacy of the allowance for doubtful accounts, we also consider customer concentrations and current economic trends. While actual bad debts recorded against the allowance for doubtful accounts have historically been within expectations and the allowance established, we cannot be sure that we will continue to be able to estimate our future experience with the same success. If the financial condition of our customers were to deteriorate, resulting in their inability to make payments, additional allowances may be required.

Inventories

We value our inventory at the lower of cost (first-in, first-out method) or market. We regularly review inventory quantities on hand and record a reserve for excess and obsolete inventory based primarily on our estimated forecast of product demand and anticipated production requirements in the near future, giving effect to general market conditions. Any rapid technological changes and future product development could result in an increase in the amount of obsolete inventory quantities on hand. Agreements with certain suppliers to our distribution business include stock rotation provisions, however, these provisions may not provide us with complete protection from loss due to excess or obsolete inventory. If our estimates of future product demand prove to be inaccurate, additional reserves may be required for incremental excess and obsolete inventory.

Goodwill, Intangible Assets and Long-Lived Assets

Goodwill and intangible assets are a result of our acquisition of TidalWire. Goodwill is tested for impairment at least annually. Intangible assets and goodwill are assessed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Any impairment loss will be charged to operations in the period of the loss. We assess the recoverability of long-lived assets, including intangible assets, based on the projected undiscounted future cash flows over the asset's remaining life. The amount of impairment, if any, is measured based on the excess of the carrying value over fair value, determined using projected discounted future operating cash flows. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. For goodwill recovery, we compare the carrying value of goodwill with its implied fair value. If the carrying value exceeds the implied fair value of the goodwill, an impairment loss is recorded

in an amount equal to that excess. Determining the fair value of individual assets and goodwill may include significant judgments by management. Different assumptions could yield materially different results.

Acquisition Accounting

In December 2002, we acquired TidalWire for total consideration of $17.6 million, which was allocated to net tangible assets and liabilities acquired of $4.4 million, deferred stock compensation of $304,000, customer relationships of $5.1 million and goodwill of $7.8 million. The fair value of the customer relationships was determined based on the discounted estimated future cash flows from these relationships. We have estimated that the useful life of these customer relationships would be five years. Significant judgments and estimates are involved in determining the fair value of assets acquired and their useful lives. Different assumptions could yield materially different results.

Restructuring and Other Charges

Involuntary termination benefits and exit costs are recognized when management approves and commits to a sufficiently detailed plan of termination or exit plan. Management must assess whether costs incurred in connection with involuntary terminations and exit activities meet certain specific requirements to be recorded and classified as restructuring and other costs. During compilation of a plan of termination or exit plan, we make certain assumptions and estimates regarding certain costs contained in these plans based on information gathered from internal and external sources. In addition, charges taken for vacant facilities are recognized when the available information indicates that a loss is probable and estimable. If actual results related to any of these assumptions or estimates were to exceed or not meet our expectations in the future, we may need to adjust certain restructuring and other charges in future reporting periods, resulting in increased or decreased operating expenses.

Stock Compensation

In connection with the grant of certain options and restricted stock awards to employees issued prior to our initial public offering in July 2000, we recorded deferred stock compensation within stockholders' equity of $15.5 million, representing the difference between the estimated fair value of the common stock for accounting purposes and the option exercise price of these options or restricted stock awards at the date of grant. Such amount is presented as a reduction of stockholders' equity and is being amortized over the vesting period of the applicable options. Significant judgments and estimates were involved in determining the proper valuation of deferred stock compensation because at the time of grant there was no available market for our common stock. Different assumptions could have yielded materially different results.

Income Tax Asset Valuation

We record deferred tax assets and liabilities based on the net tax effects of tax credits, operating loss carryforwards and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We then assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we establish a valuation allowance. The valuation allowance is based on our estimate of future taxable income and the period over which our deferred tax assets will be recoverable. Through June 30, 2003, we believe that it is more likely than not that all of our deferred tax assets will not be realized, and, accordingly, we have recorded a valuation allowance against all of our deferred tax assets. If results of

operations in the future indicate that some or all of the deferred tax assets will be recovered, the reduction of the valuation allowance will be recorded as a tax benefit during one period or over several periods.

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Results of Operations

The following table sets forth the results of our operations for the three and nine months ended June 30, 2003 and 2002, respectively, in thousands and as a percentage of net revenues.

	Three months ended				Nine months ended			
	June 30, 2003		June 30, 2002		June 30, 2003		June 30, 2002	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	% of Net Revenues
Net revenues	$27,003	100.0%	$ 4,130	100.0%	$52,418	100.0%	$ 9,265	100.0%
Gross profit	5,555	20.6%	723	17.5%	10,968	20.9%	946	10.2%
Operating expenses	5,253	19.5%	3,466	83.9%	13,894	26.5%	14,722	158.9%
Income (loss) from operations	302	1.1%	(2,743)	(66.4)%	(2,926)	(5.6)%	(13,766)	(148.6)%
Net income (loss)	$ 408	1.5%	$(2,419)	(58.6)%	$(2,455)	(4.7)%	$(12,506)	(135.0)%

Recent Events

On December 27, 2002, we completed our acquisition of TidalWire. As a result, the quarter ended March 31, 2003 was the first quarter that included the TidalWire operations in our consolidated results for an entire quarter. Our financial results for the nine months ended June 30, 2003 only include TidalWire financial results for the period from December 28, 2002 through June 30, 2003. As such, the presentation of historical financial information and any discussion regarding the comparison of historical financial information to financial information for the three or nine months ended June 30, 2003, does not include any financial information for TidalWire prior to December 28, 2002, unless otherwise indicated. Forward-looking statements made regarding our expected future operating results include the expected results of both Network Engines and TidalWire on a combined basis.

Net Revenues and Gross Profit

The following table summarizes our net revenues and gross profit by reportable segment, in thousands and as a percentage of net revenues:

Three months ended		Nine months ended	
June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002

	Dollars	% of Segment Net Revenues	Dollars	% of Segment Net Revenues	Dollars	% of Segment Net Revenues	Dollars	% of Segment Net Revenues
OEM Appliance:								
Net revenues	$14,445	100.0%	$ 4,130	100.0%	$29,275	100.0%	$ 9,265	100.0%
Gross profit	$ 2,907	20.1%	$ 723	17.5%	$ 6,411	21.9%	$ 946	10.2%
Distribution:								
Net revenues	$12,558	100.0%	--	--	$23,143	100.0%	--	--
Gross profit	$ 2,648	21.1%	--	--	$ 4,557	19.7%	--	--
Total net revenues	$27,003	100.0%	$ 4,130	100.0%	$52,418	100.0%	$ 9,265	100.0%
Total gross profit	$ 5,555	20.6%	$ 723	17.5%	$10,968	20.9%	$ 946	10.2%

Prior to our acquisition of TidalWire on December 27, 2002, our revenues were derived from sales of server appliance hardware platforms and related pre-sales integration and supply-chain management services in the United States. Sales of server

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appliances to one OEM Appliance customer have been a major portion of our revenues. We provide this customer with customized platforms that are used as components in their data storage solution. During our fiscal 2002, this OEM Appliance customer publicly announced the availability of their product. Since then we have seen quarterly increases in our OEM Appliance sales. As a result of our acquisition of TidalWire, we also distribute storage networking connectivity products through a channel of value-added resellers and systems integrators. We intend to expand upon the number of storage networking products offered by our distribution business to include products in the network security market.

The quarterly and year-to-date increases in net revenues in the third quarter and nine months ended June 30 of fiscal 2003 versus the same periods in fiscal 2002 are primarily due to incremental revenues from our recently acquired distribution business, which accounted for approximately 47% and 44% of our total net revenues in the three and nine months ended June 30, 2003, respectively. The increase in net revenues is also due to increased sales to our large OEM Appliance customer, to whom sales represented approximately 48% and 50% of total net revenues in the three and nine months ended June 30, 2003, respectively, as compared to 84% and 79% of total net revenues in the same periods of fiscal 2002. We expect that OEM Appliance sales will continue to grow as sales to our OEM Appliance customers continue to increase and as we add additional OEM Appliance customers. We believe that sales through our distribution business will continue to contribute a substantial portion of total quarterly net revenues, but we expect that OEM Appliance sales will constitute a larger portion of total net revenues than distribution sales for the remainder of fiscal 2003.

Gross profit represents net revenues recognized less the cost of revenues. Cost of revenues includes cost of materials, manufacturing costs, manufacturing personnel expenses, obsolescence charges, packaging and warranty costs. The quarterly and year-to-date increases in gross profit in the three and nine months ended June 30 of fiscal 2003 versus the same periods in fiscal 2002 are primarily due to increased OEM Appliance sales volumes, which typically carry a higher gross profit than distribution sales. In addition, incremental revenues from our distribution business in the three and nine months ended June 30, 2003 contributed to the increase in gross profits versus the same periods in fiscal 2002. To a lesser extent the increases in gross profit were due to lower manufacturing costs per unit sold as compared to manufacturing costs per unit in the third quarter and nine months ended June 30, 2002. In addition, in the three months ended June 30, 2003, rebates from certain distribution suppliers contributed to the increase in gross profit. The increases in gross profit during the three and nine months ended June 30, 2003 were offset in part by a warranty charge to OEM Appliance cost of revenues. This charge was based upon our changed estimates of the cost to fulfill warranties of server appliances sold prior to June 30, 2003. Our gross profit is affected by the product mix within our OEM Appliance business, our OEM Appliance product pricing as well as the timing, size and configuration of appliance orders. Our gross profit is also affected by the relative size of distribution revenues to OEM Appliance revenues as well as the mix of products sold through our distribution business as each of these products carries a different gross profit as a percentage of revenues. We expect gross profit to continue to be affected by these factors as well as competitive pricing pressure in both the appliance and distribution lines of business.

Operating Expenses

The following table presents operating expenses during the periods indicated, in thousands and as a percentage of net revenues:

	Three months ended				Nine months ended			
	June 30, 2003		June 30, 2002		June 30, 2003		June 30, 2002	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	% of Net Revenues
Operating Expenses:								
Research and development	$ 1,096	4.1%	$ 914	22.1%	$ 2,807	5.4%	$ 3,717	40.1%
Selling and marketing	1,933	7.2%	874	21.2%	4,372	8.3%	2,846	30.7%
General and administrative	1,741	6.5%	1,088	26.3%	4,623	8.8%	3,734	40.3%
Stock compensation	229	0.8%	237	5.7%	700	1.3%	4,072	44.0%
Amortization of intangible assets	254	0.9%	--	0.0%	508	1.0%	--	0.0%
Restructuring and other charges	--	0.0%	353	8.6%	884	1.7%	353	3.8%
Total operating expenses	$ 5,253	19.5%	$ 3,466	83.9%	$13,894	26.5%	$14,722	158.9%

Research and Development. Research and development expenses consist primarily of salaries and related expenses for personnel engaged in research and development, fees paid to consultants and outside service providers, material costs for prototype and test units and other expenses related to the design, development, testing and enhancements of our products. We

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expense all of our research and development costs as they are incurred. Research and development expenses increased in the third quarter of fiscal 2003 versus the third quarter of fiscal 2002 due to prototype and consulting costs incurred in development projects for our OEM Appliance hardware platforms, which were partially offset by decreases in compensation costs and facility-related costs as a result of reductions in research and development personnel. Research and development expenses decreased in the nine months ended June 30, 2003 versus the nine months ended June 30, 2002 due primarily to decreased compensation costs, which decreased as a result of our closure of our Austin, Texas software development center in December 2001 and our June 2002 headcount reduction, which together resulted in a reduction in research and development personnel. These headcount reductions were a result of our transition away from the use of significant proprietary technology in our products. As a result, we have significantly increased the use of standard off-the-shelf technology in our products, which has decreased our need for engineering personnel in our product design process. Prior to these headcount reductions, we had 30 people in our engineering group. At June 30, 2003, there were 19 employees in research and development. In addition, lower facility-related expenses contributed to the decrease in research and development expenses during the nine months ended June 30, 2003. The decrease in research and development expenses in the nine months ended June 30, 2003 was partially offset by increased prototype and consulting costs incurred in development projects for our OEM Appliance hardware platforms. We believe that a significant level of investment in product development is required to remain competitive and we expect to continue to devote substantial resources to product development. Our engineering process includes the utilization of standard, off-the-shelf components in our server appliance hardware platforms wherever possible. However, significant internal development efforts are required to fulfill our customers' appliance needs. As a result, we expect research and development expenses to increase during the remainder of fiscal 2003, depending on actual project activity.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in sales, marketing, business development and customer support functions, as well as costs associated with travel and marketing programs. The increases in selling and marketing expenses in the three and nine months ended June 30 of fiscal 2003 versus the same periods in fiscal 2002 were due to increased compensation costs as sales, marketing, business development and customer support personnel increased from 10 employees at June 30, 2002 to 39 employees at June 30, 2003, which was primarily due to our acquisition of TidalWire in December 2002. We expect selling and marketing expenses to increase in absolute dollars during the remainder of fiscal 2003 as we continue to expand our sales and marketing efforts to further increase our market presence. However, we expect selling and marketing expenses to remain relatively constant as a percentage of net revenues during the remainder of fiscal 2003 depending on revenue growth.

General and Administrative. General and administrative expenses consist

primarily of salaries and other related costs for executive, finance, accounting, information technology, facilities and human resources personnel, as well as legal, audit and tax fees, administrative expenses associated with operating as a public company and bad debt expenses. The increase in general and administrative expenses in the three and nine month periods ended June 30 of fiscal 2003 versus the same periods of fiscal 2002 are primarily attributable to costs associated with a legal case related to our acquisition of TidalWire. Increased compensation costs also contributed to the increases in general and administrative expenses as general and administrative personnel increased from 13 at June 30, 2002 to 17 at June 30, 2003 due to our acquisition of TidalWire in December 2002. To a lesser extent, the increases in general and administrative expenses are attributable to increased legal, audit and tax and insurance expenses due to the rising costs associated with our operation as a public company. In the first quarter of fiscal 2003, we recorded a reserve against certain receivables from our sub-tenant, which contributed to the increase in general and administrative expenses in the nine months ended June 30, 2003. In the first quarter of fiscal 2003, we reversed reserves against shareholder notes receivable and in the second quarter of fiscal 2002, we settled a lawsuit brought against us by a former employee, which partially offset the increase in general and administrative expenses in the nine months ended June 30, 2003. We expect general and administrative expenses to remain relatively constant in absolute dollars during the remainder of fiscal 2003 and we expect general and administrative expenses to decrease as a percentage of revenues during the remainder of fiscal 2003 depending on revenue growth.

Stock Compensation. We recorded deferred stock compensation on our balance sheet of $15.5 million in connection with stock option and restricted stock grants to our employees and directors that were granted between February 1, 1999 and June 30, 2000. This amount represents the difference between the exercise price and the deemed fair value of our common stock for financial reporting purposes at the date of grant. We are amortizing this stock compensation over the vesting period of the related options. All options granted subsequent to June 30, 2000 have been issued with exercise prices equal to the fair market value of our common stock and, accordingly, no additional deferred compensation has been recorded. Through June 30, 2003, we amortized $7.8 million to stock compensation expense and $7.1 million of deferred stock compensation has been reversed due to the cancellation of options for terminated employees.

We recorded $6.4 million of deferred compensation on our balance sheet as a result of restricted stock issued to the former employees of IP Performance, Inc. ("IP Performance"). In December 2001, we terminated the employment of all of the former IP Performance employees. In accordance with the restricted stock agreements, all of the remaining unvested restricted stock vested

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upon termination. As a result, we recognized the remaining deferred stock compensation of approximately $3.5 million in December 2001.

In connection with our acquisition of TidalWire, we assumed all of TidalWire's outstanding options, which converted into options to purchase 1,035,033 shares of our common stock. We recorded approximately $304,000 of deferred stock compensation on our balance sheet related to unvested options. This amount represents the difference between the exercise price and the fair market value of our common stock on the option conversion date. We are amortizing this deferred stock compensation over the remaining vesting period of the related

options. Through June 30, 2003, we amortized $134,000 to stock compensation expense and $62,000 of deferred stock compensation has been reversed due to the cancellation of options for terminated employees.

The decrease in stock compensation expense in the third quarter of fiscal 2003 versus the third quarter of fiscal 2002 is due to the reversal of deferred stock compensation associated with unvested options cancelled in conjunction with employee terminations in fiscal 2002. Additional amortization of deferred stock compensation attributable to our acquisition of TidalWire partially offset this decrease in stock compensation. The decrease in stock compensation expense in the nine months ended June 30, 2003 versus the nine months ended June 30, 2002 is due to the accelerated amortization of $3.5 million of deferred stock compensation recorded in December 2001 as a result of our closure of our Austin, Texas development center and the termination of employee stockholders as a result of this facility closure. There was no comparable charge in the nine months ended June 30, 2003. We expect quarterly stock compensation amortization of approximately $242,000 during the remainder of fiscal 2003 and an aggregate of approximately $433,000 thereafter. The amount of stock compensation expense to be recorded in future periods could change if restricted stock or options for accrued but unvested compensation are forfeited.

Amortization of intangible assets. In connection with our acquisition of TidalWire, we engaged an independent valuation firm to evaluate the intangible assets generated as a result of the acquisition. As a result of this valuation work, we recorded approximately $5.1 million of intangible assets attributable to TidalWire's existing customer relationships as of December 27, 2002. We estimated the useful life of the relationships to be five years and as such, we are amortizing the related intangible assets on a straight-line basis over five years. We expect quarterly amortization of intangible assets of approximately $254,000 through December 31, 2007.

Restructuring and other charges. In the first quarter of fiscal 2003, we recorded a charge to operations of $914,000. This charge was comprised entirely of future lease and lease-related payments and resulted from the continued vacancy of certain leased facilities and the expected future vacancy of certain leased facilities currently occupied by a sub-tenant. This change in estimated sub-lease income and related charge was determined through an analysis of the real estate market in and around these facilities, the likelihood that these facilities could be leased during the remainder of the existing lease terms and the financial condition of our sub-tenant. In the second quarter of fiscal 2003, we received unanticipated sub-lease income of approximately $30,000 from our existing sub-tenant. As a result, we recorded a $30,000 reversal of the associated restructuring accrual as a decrease to restructuring and other charges.

Interest and other income, net

Interest and other income, net decreased to $106,000 and $471,000 in the three and nine months ended June 30, 2003, respectively, versus $324,000 and $1.3 million in the three and nine months ended June 30, 2002. This decrease was due to lower average interest rates earned on our cash equivalents and a lower average cash and cash equivalents balance in fiscal 2003 as a result of utilizing cash and cash equivalents to fund net operating losses incurred since June 30, 2002 and to fund our acquisition of TidalWire in December 2002.

Liquidity and Capital Resources

Since fiscal 1997, we have financed our operations primarily through the sale of equity securities, borrowings and the sale of our products. On July 18, 2000, we completed our initial public offering by selling 7,475,000 shares of common

stock, including the exercise of the underwriters' over-allotment option of 975,000 shares, at $17 per share and raised approximately $116.9 million, net of offering costs and underwriting fees totaling approximately $10.2 million. Prior to the initial public offering, we raised approximately $37.3 million, net of offering costs, from the issuance of preferred stock. As of June 30, 2003, we had $38.6 million in cash and cash equivalents.

Cash used in operating activities was $3.6 million in the nine months ended June 30, 2003, which, excluding the effects of TidalWire assets and liabilities acquired, was primarily due to our net loss of $2.5 million and increases in inventories and accounts receivable and was partially offset by an increase in accounts payable and non-cash charges for depreciation and amortization and stock compensation. Cash used in operating activities in the nine months ended June 30, 2002 was $13.3 million and was primarily due to our net loss of $12.5 million, decreases in the amount due to a former contract manufacturer and accrued expenses and an increase in inventories and was partially offset by non-cash charges for stock compensation and depreciation and amortization and an increase in accounts payable.

Cash used in investing activities was $4.5 million and $171,000 in the nine months ended June 30, 2003 and 2002, respectively. Cash used in investing activities in the nine months ended June 30, 2003 was primarily due to the cash paid as part of our acquisition of TidalWire in December 2002, including transaction costs, and was offset in part by the sale of short-term securities and refunds and repayments of restricted cash. Cash used in investing activities was primarily due to purchases of property and equipment and changes in other assets during the nine months ended June 30, 2002.

Cash provided by (used in) financing activities was $148,000 and ($2.7 million) in the nine months ended June 30, 2003 and 2002, respectively. Cash used in financing activities during both periods was primarily for repurchases of common stock under our $5.0 million stock repurchase program and was offset by cash provided by the issuance of common stock through the exercise of employee stock options and our employee stock purchase plan and the collection of stockholder notes receivable.

In August 2001, the Board of Directors authorized the repurchase of up to $5.0 million of our common stock from time to time on the open market or in non-solicited privately negotiated transactions. In November 2002, we completed the stock repurchase program. Through the end of this program, we repurchased approximately 4,594,000 shares of common stock for approximately $4.6 million of cash and repurchased approximately 589,000 shares of common stock in exchange for the cancellation of approximately $411,000 of stockholder notes receivable.

As a result of the restructurings that we implemented in our fiscal 2001 and 2002 and the three months ended December 31, 2002, we are obligated to make additional cash payments of approximately $537,000 over the next twelve months and $304,000 thereafter. We anticipate that funds required to make all restructuring payments will be available from our current working capital. We believe that the restructuring actions undertaken during the three months ended December 31, 2002 will result in reduction of our operating expenses of approximately $84,000 during the remainder of fiscal 2003, approximately $438,000 during fiscal 2004 and approximately $237,000 during fiscal 2005.

In January 2001, we deposited $1.1 million of cash with a bank to guarantee a personal loan of Lawrence A. Genovesi, our current Chairman and former President, Chief Executive Office and Chief Technology Officer. This guarantee was made in order to avoid significant sales of our stock by Mr. Genovesi as a result of a margin call on a personal loan collateralized by Mr. Genovesi's holdings of our stock. In conjunction with our guarantee of this loan, we entered into an agreement whereby Mr. Genovesi agreed to reimburse us for any obligations incurred by us under the guarantee. On January 6, 2003, the bank applied $968,596 of our funds that were on deposit with the bank in satisfaction of all amounts due to the bank from Mr. Genovesi and refunded $83,254 to us. On January 27, 2003, Mr. Genovesi repaid us $974,168 to satisfy his obligations to us in full under the reimbursement agreement. Of that amount, $456,276 was paid in cash and $517,892 was paid with the proceeds from the repurchase by us of 391,128 shares of our common stock owned by Mr. Genovesi in a private transaction.

During fiscal year 2002, we repurchased 328,572 shares of common stock held by Mr. Genovesi at a cost of $248,000. Of the purchase price, $203,000 was applied against Mr. Genovesi's outstanding loans due to us, while the remaining $45,000 was paid in cash to Mr. Genovesi. Mr. Genovesi also repaid $15,000 due to us under his remaining outstanding loans. On January 27, 2003, Mr. Genovesi, repaid to us a recourse note payable of $22,500 with proceeds from our repurchase of 17,070 shares of our common stock owned by Mr. Genovesi.

In April 2001, we entered into five recourse loans with certain of our officers and employees at that time totaling approximately $736,000, which was recorded net of a reserve of $228,000. We entered into these loan agreements to avoid substantial sales of our common stock by these individuals as a result of their alternative minimum tax obligations incurred as a result of their exercise of common stock options. The loans had an interest rate of 4.63% per year and were due, as amended, in September 2002. These officers and employees pledged to us all shares of our common stock owned by them, all common stock options held by them and all proceeds received by them on the sale of either our common stock or common stock options. During fiscal year 2002, we received proceeds from loans principal and interest payments of approximately $30,000; we repurchased 260,777 shares of common stock as repayment for principal and interest for an additional $267,000. In January 2003, the remaining loans of approximately $489,000 were repaid in full, including accrued interest, through our repurchase of 278,600 shares of our common stock.

In connection with our acquisition of TidalWire, we paid $1,144,615 to Ascent Venture Partners (together with its affiliated entities, "Ascent") and $2,205,828 to HarbourVest Partners (together with its affiliated entities, "HarbourVest"), two of our substantial stockholders. At the time of the acquisition, Ascent and HarbourVest owned approximately 18.1% and 16.3% of our outstanding common stock, respectively. Ascent and HarbourVest also owned 12.9% and 24.9% of the outstanding common stock of TidalWire, respectively. Pursuant to the terms of the merger agreement, we issued 480,706 shares and 926,386 shares of its common stock previously held as treasury stock to Ascent and HarbourVest, respectively and made the aforementioned cash payments to Ascent and HarbourVest in exchange for all of the TidalWire common stock held by Ascent and HarbourVest.

In connection with the TidalWire acquisition, we engaged Akibia, Inc. ("Akibia") to provide certain customer support and warranty fulfillment services. Akibia charges us a fee for these services based upon sales of certain of our products. A director of ours is also a director of PSI Holding Group, Inc. ("PSI") the parent company of Akibia. In addition, Ascent and HarbourVest

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each own greater than 5% of our outstanding stock and greater than 5% of the outstanding stock of PSI. In the three and nine months ended June 30, 2003, we recognized $335,000 and $646,000 of expense as a result of our agreements with Akibia. At June 30, 2003, we had a payable to Akibia of $115,000.

The following table sets forth future payments that we are obligated to make under capital and operating lease commitments as of June 30, 2003 (in thousands):

Contractual obligations	Remainder of year ending September 30,	Year ending September 30,		
	2003	2004	2005	Total
Operating leases	$ 229	$ 916	$ 356	$1,501
Capital leases	2	--	--	2
Total contractual cash obligations	$ 231	$ 916	$ 356	$1,503

Our future liquidity and capital requirements will depend upon numerous factors, including:

*the timing and size of orders from our largest customer;

*our ability to form an adequate number of strategic partnerships with ISVs, resellers, integrators and suppliers;

*our ability to distribute server appliances for software companies through our newly acquired distribution business;

*our ability to maintain and increase the revenues from our newly acquired distribution business;

*the level of success of our strategic OEM Appliance partners in selling server appliance solutions that include our server appliance hardware platforms;

*our ability to successfully integrate our recently acquired distribution business into our existing server appliance business;

*the costs and timing of product engineering efforts and the success of these efforts; and

*market developments.

We believe that our available cash resources, including cash and cash equivalents, together with cash we expect to generate from sales of our products will be sufficient to meet our operating and capital requirements through at least the next twelve months. After that, we may need to raise additional funds. We may seek to raise additional funds through borrowings, public or private equity financings or from other sources. There can be no assurance that additional financing will be available at all or, if available, will be on terms acceptable to us. If additional financing is needed and is not available on acceptable terms, we may need to reduce our operating expenses.

Recent Accounting Pronouncements

In November 2002, the FASB issued FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34 ("FIN 45"). FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It also incorporates, without change, the guidance in FASB Interpretation No. 34, "Disclosure of Indirect Guarantees of Indebtedness of Others," which is being superseded. The disclosure provisions of FIN 45 are effective for financial statements of interim or annual periods that end after December 15, 2002 and the provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor's year-end. The adoption of FIN 45 did not have a material impact on our financial position or results of operations.

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In November 2002, the Emerging Issues Task Force of the FASB reached a consensus on Issue 00-21, Accounting for Revenue Arrangements with Multiple Deliverables ("EITF 00-21"). EITF 00-21 requires that for revenue arrangements with multiple deliverables, those deliverables be divided into separate units of accounting if the deliverables meet certain criteria as defined by EITF 00-21. Arrangement consideration is to be allocated among the separate units of accounting based on their relative fair values and revenue recognition decisions should be considered separately for each separate unit of accounting. EITF 00-21 is effective for all arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted. We are currently evaluating the scope of EITF 00-21, however, we do not expect the adoption of EITF 00-21 to have a material impact on our financial position or results of operations.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 "Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity" ("SFAS 150") which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS 150 requires that an issuer classify a financial instrument that is within its scope as a liability if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception,

variations in something other than the fair value of the issuer's equity shares or variations inversely related to changes in the fair value of the issuer's equity shares. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 is not expected to have a material impact on our financial position or results of operations.

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

The risks and uncertainties described below are not the only ones we are faced with. Additional risks and uncertainties not presently known to us, or that are currently deemed immaterial, may also impair our business operations. If any of the following risks actually occur, our financial condition and operating results could be materially adversely affected.

Risks of dependence on one strategic partner.

We derive a significant portion of our revenues from one customer, and our revenues may decline significantly if this customer cancels or delays purchases of our products, terminates their contract with us, or exercises certain of their other rights under the terms of the contract.

In the three and nine months ended June 30, 2003, one customer accounted for 48% and 50% of our total net revenues, respectively. Under the terms of a non-exclusive contract with this customer, the customer has the right to enter into agreements with other parties for similar products, the customer is not obligated to purchase any minimum quantity of products from us and the customer may choose to stop purchasing from us at any time. In addition, the customer may terminate the agreement in the event that we attempt to assign its rights under the agreement to another party without the customer's prior approval. Furthermore, in the event that we default on certain portions of the agreement and do not cure during the prescribed cure period, the customer may obtain the right to manufacture the products defined in the agreement in exchange for a mutually agreeable royalty fee. If any of these events were to occur, or if this customer delays purchases of our products, our revenues and operating results would be adversely affected, our reputation in the industry may suffer and our ability to predict cash flow accurately would decrease.

Our distribution business relies on reference sales originating from our largest customer and our business would suffer if we lost these reference sales.

A significant portion of our distribution revenues are derived from reference sales of products, which are approved for configuration in the data storage networks sold by our largest customer. We are one of two North American distributors that this customer refers its customers to for the supply of data storage network components that have been authorized for use in this customer's data storage networks. We expect this to continue in the future. These reference sales have historically had a higher margin and have represented a substantial amount of TidalWire's revenues as compared to revenues from other sales. If we were to lose these reference sales or if the margins we derive from such sales were reduced to any significant degree, our results of operations and financial condition would suffer.

Risks related to business strategy.

Our future success is dependent on our ability to generate significant revenues from strategic partnerships with independent software vendors ("ISVs").

A major component of our business strategy is to focus our selling and marketing

efforts on indirect sales through strategic partnerships with ISVs. To date, we have not entered into a significant number of definitive agreements with ISVs. Even if we are successful in developing a significant number of strategic partnerships with ISVs, we are reliant on our partners' ability to create

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demand for their server appliance solutions. If we engage ISV partners whose products are technologically inferior to competitive products, sales of our ISV partners' server appliance solutions may be limited and our revenues and operating results may suffer. If we engage ISV partners who do not commit an adequate level of resources to promoting their server appliance solutions, sales of these server appliance solutions could be limited, which could cause our revenues and operating results to suffer. In addition, our server appliance strategy requires us to expend a significant level of engineering, selling and marketing resources for each of our ISV partners. If we fail to generate enough revenues to offset the financial demands that our strategy places on our business, our future operating results will suffer.

As a result of our acquisition of TidalWire, we can now sell our ISV partners' server appliance solutions through our distribution channel. If we are unsuccessful in our efforts to sell our ISV partners' server appliance solutions through our distribution channel, our revenues and operating results may suffer.

One of the reasons that we acquired TidalWire was to utilize TidalWire's distribution channel to sell our current and future partners' server appliance solutions. Since our acquisition of TidalWire, we have begun distributing certain of our partners' server appliance solutions through our newly acquired channel of resellers and systems integrators. However, we have limited experience in selling and marketing server appliances through our distribution channel. To successfully sell our ISV partners' server appliance solutions through our distribution channel we must work extensively with our ISV partners' selling and marketing personnel and our reseller and systems integrator partners. We may find that the amount of time and resources that are required to effectively sell our partners' server appliance solutions through our distribution channel is more significant than was originally planned. If we are unable to generate sufficient revenues through sales of our partners' server appliance solutions through our distribution channel, our operating results may suffer and we may determine that we need to discontinue this component of our business strategy.

We plan to increase the number of resellers we support and to add additional data storage networking products to our distribution product line. If we fail to increase the number of resellers or fail to add additional products to our distribution product line, our revenues and operating results may be adversely affected.

Historically, TidalWire has grown its business by increasing the number of its reseller and system integrator partners and by increasing the number of data storage networking products it supports. We believe that, in order to continue to grow this distribution business, we must add additional reseller and system integrator partners and to further expand the products offered. If we fail to increase the number of resellers or fail to add additional products to our distribution product line, our revenues and operating results may be adversely affected.

In addition to the data storage market, we plan to focus our sales and marketing efforts in the network security market. If we are not successful in expanding in this market, our revenue growth may be limited and our operating results may be adversely affected.

With a substantial amount of our server appliance business heavily concentrated in our large OEM data storage customer and TidalWire's current business of distributing storage connectivity products, we believe we have established a good working knowledge of the data storage market. In order to expand our business into the network security market, we may need to expend substantial resources and it may take us longer to establish strategic partnerships in this market due to our lack of experience in the network security market. If we are not successful in expanding in this market, our revenue growth may be limited and our operating results may be adversely affected.

Risks related to the server appliance, data storage and network security markets.

If server appliances are not increasingly adopted as a solution to meet companies' computer application needs, the market for our server appliance products may not grow and the market price of our common stock could decline as a result of lower revenues or reduced investor expectations.

We expect that a substantial portion of our revenues will come from sales of server appliance platforms and customized integration services and, eventually, the sale of server appliances through our distribution channel. As a result, we depend on the growing use of server appliances to meet businesses' storage and security network application needs. The market for server appliance products has only recently begun to develop and we believe it is evolving rapidly. Because this market is new, we cannot predict its potential size or future growth rate with a high degree of certainty. Our revenues may not grow and the market price of our common stock could decline if the server appliance market does not grow rapidly.

We believe that our expectations for the growth of the server appliance market may not be fulfilled if customers continue to use general-purpose servers. The role of our products could, for example, be limited if general-purpose servers become better at

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performing functions currently being performed by server appliances or are offered at a lower cost. This could force us to further lower the prices of our products or result in fewer sales of our products.

Server appliance products are subject to rapid technological change due to changing operating system software and network hardware and software configurations, and our server appliance sales will suffer if our server appliance products are rendered obsolete by new technologies.

The server appliance market is characterized by rapid technological change, frequent new product introductions and enhancements, potentially short product life cycles, changes in customer demands and evolving industry standards. We attempt to mitigate these risks by utilizing standards-based hardware platforms and by maintaining an adequate knowledge base of available technologies. However, our server appliance products could be rendered obsolete if products

based on new technologies are introduced or new industry standards emerge and we are not able to incorporate these technological changes into our products.

Our future success depends upon our ability to utilize our creative packaging and hardware and software integration skills to combine industry-standard hardware and software to produce low-cost, high-performance server appliance products that satisfy our strategic partners' requirements and achieve market acceptance. We cannot be certain that we will successfully identify new product opportunities and develop and bring new products to market in a timely and cost-effective manner.

The cyclical nature of the data storage industry could hurt our operating results.

The data storage industry has historically been characterized by fluctuations in product demand and supply, and, consequently, severe fluctuations in price. Over the past year, the industry in which our newly acquired distribution business operates has experienced a significant downturn in demand and excess production levels. Although our distribution agreements with manufacturers provide us with limited price protection and certain rights of return, any shortfalls in demand and excess production could hurt our distribution sales and gross margins. If any such shortfalls in demand and excess production were to continue for a prolonged period of time, our results of operations would be adversely affected. In addition, many of our reseller and system integrator customers in the data storage industry are subject to the risks of significant shifts in demand and severe price pressures by their customers, which may increase the risk that we may not be able to collect accounts receivable owed by some of our customers. If we are unable to collect accounts receivable, our results of operations and financial condition may suffer.

If the data storage industry experiences significant unit volume growth that, in turn, results in increased demand for many of the products we distribute, we may experience a shortage of our products. In such event, our operating results may depend on the amount of product allocated to us by manufacturers and the timely receipt of such product.

Data storage and network security products are subject to rapid technological change and our distribution sales will suffer if the products that we currently distribute, or if our newest or future products, are rendered obsolete by new technologies.

The data storage and network security markets are characterized by rapid technological change, frequent new product introductions and enhancements, potentially short product life cycles, changes in customer demands and evolving industry standards. If data storage vendors develop products that incorporate the functionality of the data storage components that we distribute, the marketability of the products that we distribute will suffer and our distribution sales will be materially affected. We do not have extensive experience in the network security market and if we are unable to provide the appropriate products for the network security market, our distribution sales will suffer.

Risks related to competition.

If we are not able to effectively compete against providers of general-purpose servers, specific-purpose servers or other server appliance providers, our server appliance revenues will not increase and may decrease.

In the server appliance market, we face significant competition from a number of different types of companies. Our competitors include companies who market

general-purpose servers, specific-purpose servers and server appliances as well as companies that sell custom integration services utilizing hardware produced by other companies. Many of these companies are larger than we are and have greater financial resources and name recognition than we do as well as significant distribution capabilities and larger, more established service organizations to support their products. Our large competitors may be able to leverage their existing resources, including their extensive distribution capabilities and their service organizations, to provide a wider offering of products and services as well as higher levels of support on a more cost-effective basis than we can. In addition, competing companies may be able to undertake more extensive promotional activities, adopt more aggressive pricing policies and offer more attractive terms to their customers than we can. If our competitors provide lower cost solutions with greater functionality or support than our products, or if some of their products are comparable to ours and are offered as part of a range of products that is broader than ours, our products could become undesirable. Even if the functionality of competing products is equivalent to ours, we face a substantial risk that a significant number of customers would elect to pay a premium for similar

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functionality rather than purchase products from a less-established vendor. We attempt to differentiate ourselves from our competition by offering a wide variety of software integration, branding, supply-chain management, distribution and fulfillment services. If we are unable to effectively differentiate our products from those of our competition, our revenues will not increase and may decline. Furthermore, increased competition could negatively affect our business and future operating results by leading to price reductions, higher selling expenses and a reduction in our market share.

The data storage and network security markets are highly competitive and competition could reduce our market share and harm our ability to sell the products we currently offer or may offer in the future.

The data storage industry is highly competitive. As a result of our acquisition of TidalWire, we now compete against a variety of third parties including other commercial distributors of data storage products. As we enter the network security market, the number of companies that we compete with will increase. Some of our current and future competitors have significantly greater financial, technical, marketing, distribution and other resources than we do and may be able to respond more quickly than us to new or emerging technologies and changes in customer requirements, which could reduce our market share. These competitors may also establish or strengthen cooperative relationships with our key customers and other parties with whom we have strategic relationships, which could harm our ability to distribute our current and future products.

Our revenues could be negatively affected if our larger competitors make acquisitions in order to join their extensive distribution capabilities with our smaller competitors' products.

Large server manufacturers may not only develop their own server appliance solutions, but they may also acquire or establish cooperative relationships with our smaller competitors, including smaller private companies. Because large server manufacturers have significant financial and organizational resources available, they may be able to quickly penetrate the server appliance market by leveraging the technology and expertise of smaller companies and utilizing their

own extensive distribution channels. We expect that the server industry will experience further consolidation. It is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share through consolidation. Consolidation within the server marketplace could adversely affect our revenues.

We may sell fewer products if other vendors' products are no longer compatible with our products or other vendors bundle their products with those of our competitors and sell them at lower prices.

Our ability to sell our products depends in part on the compatibility of our products with other vendors' software and hardware products. Developers of these products may change their products so that they will no longer be compatible with our products. These other vendors may also decide to bundle their products with other server appliances for promotional purposes and discount the sales price of the bundle. If that were to happen, our business and future operating results could suffer if we were no longer able to offer commercially viable products.

Risks related to financial results.

We have a history of losses and may continue to experience losses in the future, which could result in the market price of our common stock declining further.

Since our inception, we have incurred significant net losses and although we were profitable in the three months ended June 30, 2003, we could incur net losses in the future. At June 30, 2003, we had an accumulated deficit of $110.0 million. We believe that any future growth will require us to incur significant engineering, selling and marketing and administrative expenses. As a result, we will need to generate significant revenues to sustain profitability. We cannot be certain that we will be able to sustain profitability in the future. If we do not maintain profitability, the market price for our common stock may decline.

Our quarterly revenues and operating results may fluctuate, which could cause our operating results to fall below expectations and cause the market price of our common stock to decline.

Our quarterly revenues and operating results are difficult to predict and may fluctuate significantly from quarter to quarter. None of our customers are obligated to purchase any quantity of our products in the future. Our operating expense levels are based in part on expectations of future revenues. If revenues or gross margins in a particular quarter do not meet expectations, operating results could suffer and the market price of our common stock could decline. Factors affecting quarterly operating results include:

*the timing and size of orders from customers, particularly our largest customer;

*the loss of key suppliers or customers;

*the mix of server appliance revenues and distribution revenues and the product mix within each;

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*the ability to expand our production capacity;

*the availability of products from suppliers;

*price competition;

*changing economic conditions in North America; and

*the timing of expenditures in anticipation of increased revenues.

If the commoditization of products and competition in the server appliance market increases, then our gross profit as a percentage of net revenues may decrease and our operating results may suffer.

Products and services in the server appliance market may be subject to further commoditization as the industry matures and other businesses introduce more competing products and services. The gross margin as a percentage of revenues of our products is already low, and may not grow to our targeted gross margin percentages or may even decrease, in response to changes in our product mix, competitive pricing pressures, or new product introductions into the server appliance marketplace. If we are unable to offset decreases in our gross margins as a percentage of revenues by increasing our sales volumes, operating results will decline. Changes in the mix of sales of our products, including the mix of higher margin sales of products sold in smaller quantities and somewhat lower margin sales of products sold in larger quantities, could adversely affect our operating results for future quarters. To maintain our gross margins, we also must continue to reduce the manufacturing cost of our server appliance products. Our efforts to produce higher margin products, continue to improve our products and produce new server appliance products may make it difficult to reduce our manufacturing cost per product. Further, utilization of a contract manufacturer may not allow us to reduce our cost per product.

Risks related to marketing and sales efforts.

We need to effectively manage our sales and marketing operations to increase market awareness and sales of our products and to promote our brand recognition. If we fail to do so, our growth will be limited.

Although we have a relatively small selling and marketing organization, we must continue to increase market awareness and sales of our products. In the fast growing market for server appliance solutions, we believe that we need software companies to recognize Network Engines as a top-tier provider of server appliance platforms, custom integration services and server appliance distribution services to compete successfully. In the market for storage connectivity and network security products, we believe that we need resellers and integrators to recognize TidalWire as a leading value-added distributor of these products. If we are unable to design and implement effective marketing campaigns or otherwise fail to promote and maintain the Network Engines and TidalWire brands, our sales may not increase and our business may be adversely affected. Our business may also suffer if we incur excessive expenses promoting and maintaining these brands but fail to achieve the expected or desired increase in revenues.

If we are unable to effectively manage our customer service and support activities, we may not be able to retain our existing customers and attract new

customers.

We need to effectively manage our customer support operations to ensure that we maintain good relationships with our customers. If our customer support organization is unsuccessful in maintaining good customer relationships, we may lose customers to our competitors and our reputation in the market could be damaged. As a result, we may lose revenue and incur losses greater than expected.

Risks related to product manufacturing.

Our dependence on sole source and limited source suppliers for key components makes us susceptible to supply shortages due to lack of availability and potential quality issues that could prevent us from shipping customer orders on time, if at all, and could result in lost sales or customers.

We depend upon single source and limited source suppliers for our industry-standard processors, main logic boards, certain disk drives, and power supplies as well as our internally developed heat-pipe, chassis and sheet metal parts. We also depend on limited sources to supply several other industry-standard components. We have in the past experienced, and may in the future experience, shortages of or difficulties in acquiring components needed to produce our products. Shortages have been of limited duration and have not yet caused material delays in production of our products. However, shortages in supply of these key components for an extended time would cause delays in the production of our products, prevent us from satisfying our contractual obligations and meeting customer expectations, and result in lost sales or customers. If we are unable to buy components that we need or if we are unable to buy components at acceptable prices, we will not be able to manufacture and deliver our products on a timely or cost-effective basis to our customers.

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Our future success is dependent on our ability to expand production capacity.

Our existing manufacturing facility is limited in its production capacity. For us to be successful our product sales volumes must increase significantly. Our production capacity must increase to support significant increases in product sales volumes. In order to increase our production capacity, we utilize the services of a contract manufacturer. Using a contract manufacturer increases the cost of producing products and, in the event that we need to change contract manufacturers, we could experience transitional difficulties including production delays and quality control issues, which could cause customer relationships to suffer and result in lost sales. Also, the use of a contract manufacturer does not guarantee us production levels, manufacturing line space or manufacturing prices, which could interrupt our business operations and have a negative effect on operating results.

If we do not accurately forecast our component and product requirements, our business and operating results could be adversely affected.

We use rolling forecasts based on anticipated product orders to determine our component requirements. Lead times for materials and components that we order vary significantly and depend on factors including specific supplier requirements, contract terms and current market demand for those components. In addition, a variety of factors, including the timing of product releases,

potential delays or cancellations of orders and the timing of large orders, make it difficult to predict product orders. As a result, our component and product requirement forecasts may not be accurate. If we overestimate our component and product requirements, we may have excess inventory, which would increase costs and negatively impact our cash position. If we underestimate our component and product requirements, we may have inadequate inventory, which could interrupt our manufacturing and delay delivery of our products to customers. Any of these occurrences would negatively impact our business and operating results.

Our storage distribution business is dependent on certain suppliers and our business would suffer if we lost any significant suppliers or faced a product shortage.

Our storage distribution business is highly dependent on suppliers for substantially all of the products that it sells. A small number of suppliers provided products that historically represented a significant majority of TidalWire's storage distribution sales. The loss of any significant supplier could harm our financial condition and results of operations. Our storage distribution agreements are cancelable on short notice. Our reliance on a small number of suppliers for our storage distribution business leaves us vulnerable to having an inadequate supply of required products, price increases, late deliveries and poor product quality. Historically, from time to time TidalWire, like other distributors in its industry, has experienced supply shortages and was unable to purchase its desired volume of products. If we are unable to enter into and maintain satisfactory distribution arrangements with leading suppliers and an adequate supply of products, our revenues could suffer considerably.

Risks related to product dependence on intellectual property and use of the Network Engines and TidalWire brands.

Our reliance upon contractual provisions, domestic patent, copyright and trademark laws and applied-for patents to protect our proprietary rights may not be sufficient to protect our intellectual property from others who may sell similar products.

Certain of our products are differentiated from those of our competitors by our internally developed software and hardware and the manner in which they are integrated into our products. If we fail to protect our intellectual property, other vendors could sell products with features similar to ours, and this could reduce demand for our products. We believe that the steps we have taken to safeguard our intellectual property afford only limited protection. Others may develop technologies that are similar or superior to our technology or design around the copyrights and trade secrets we own. Despite the precautions we have taken, laws and contractual restrictions may not be sufficient to prevent misappropriation of our technology or deter others from developing similar technologies. In addition, there can be no guarantee that any of our patent applications will result in patents, or that any such patents would provide effective protection of our technology.

In addition, the laws of the countries in which we decide to market our services and solutions may offer little or no effective protection of our proprietary technology. Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it, which would significantly harm our business.

We have invested substantial resources in developing our server appliance products and the Network Engines brand, and our operating results would suffer if we were subject to a protracted infringement claim or one that resulted in a significant damages award.

Substantial litigation regarding intellectual property rights and brand names exists in the server appliance industry. We expect that server appliance products may be increasingly subject to third-party infringement claims as the number of competitors in the industry segment grows and the functionality of products in different industry segments overlaps. From time to time we

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receive claims from third parties that our products have infringed their intellectual property rights. We do not believe that our products employ technology that infringes any proprietary rights of third parties. However, third parties may make claims that we have infringed upon their proprietary rights. Any claims, with or without merit, could:

*be time-consuming to defend;

*result in costly litigation, including potential liability for damages;

*divert our management's attention and resources;

*cause product shipment delays; or

*require us to enter into royalty or licensing agreements.

Royalty or licensing agreements may not be available on terms acceptable to us, if at all. A successful claim of product infringement against us or the failure or inability to license the infringed or similar technology could adversely affect our business because we would not be able to sell the impacted product without redeveloping it or incurring significant additional expenses.

Other risks related to our business.

A disruption in the operations of our distribution center could have a material adverse effect on our financial condition and results of our operations.

Our distribution center in Memphis, Tennessee handles much of the distribution of the products of our newly acquired data storage distribution business. This distribution center, and thus our distribution operations, are vulnerable to damage or interruption from fire, flood, power loss, break-ins and similar events. We have no formal disaster recovery plan, however, we believe that we have the ability to mitigate this risk through alternative means of delivering our distribution products to our customers. The occurrence of unanticipated problems at the distribution center, all of which may not be covered by insurance, could cause interruptions or delays in our distribution business, which would have a material adverse effect on our financial condition and results of operations.

If our products fail to perform properly and conform to specifications, our customers may demand refunds or assert claims for damages and our reputation and operating results may suffer.

Because our server appliance hardware platforms are complex, they could contain errors that can be detected at any point in a product's life cycle. In the past we have discovered errors in some of our products and have experienced delays in the shipment of our products during the period required to correct these errors or we have had to replace defective products that were already shipped. These delays and replacements have principally related to new product releases. Errors in our products may be found in the future and any of these errors could be significant. Detection of any significant errors may result in:

*the loss of or delay in market acceptance and sales of our products;

*diversion of engineering resources;

*the loss of existing customers;

*injury to our reputation; or

*increased maintenance and warranty costs.

These problems could harm our business and future operating results. Product errors or delays could be material, including any product errors or delays associated with the introduction of new products or the versions of our products that support Windows or UNIX-based operating systems. While we attempt to limit our risk contractually, if our products fail to conform to warranted specifications, customers could demand a refund for the purchase price or assert claims for damages.

Moreover, because our products may be used in connection with critical computing systems services, we may receive significant liability claims if our products do not work properly. Our agreements with customers typically contain provisions intended to limit our exposure to liability claims. However, these limitations may not preclude all potential claims. Liability claims could exceed our insurance coverage and require us to spend significant time and money in litigation or to pay significant damages. Any claims for damages, even if unsuccessful, could seriously damage our reputation and business.

Class action lawsuits have been filed against us, our Board of Directors, our chairman and one of our executive officers.

On or about December 3, 2001, a class action lawsuit relating to our initial public offering was filed against us, our chairman, one of our executive officers and the underwriters of our initial public offering. In addition, on or about January 7, 2003, a purported class action lawsuit was filed against us and our Board of Directors relating to the acquisition of TidalWire Inc. We are unable to predict the effects of these suits, or other similar suits, on our financial condition and business and, although we maintain certain insurance coverage, there can be no assurance that these claims will not result in substantial monetary damages in excess of such insurance coverage. In addition,

we may expend significant resources to defend these cases. These class action lawsuits, or other similar suits, could negatively impact both our financial condition and the market price of our common stock.

Future sales by existing stockholders could depress the market price of our common stock.

Sales of a substantial number of shares of our common stock by existing stockholders could depress the market price of our common stock and impair our ability to raise capital through the sale of additional equity securities.

If we fail to retain and attract appropriate levels of qualified technical personnel, we may not be able to develop and introduce our products on a timely basis.

We require the services of qualified technical personnel. We have experienced the negative effects of an economic slowdown. In the past, we have experienced significant declines in our revenues and, since our fiscal year ended September 30, 2000 the market price of our common stock has decreased significantly. As a result, we have implemented various personnel reductions, which have placed added pressure on the remaining employees and management. These and other factors may make it difficult for us to retain and attract the qualified employees and management that we need to effectively manage our business operations, including key engineering activities. If we are unable to retain and attract a sufficient number of technical personnel we may not be able to complete development of, or upgrade or enhance, our products in a timely manner or successfully integrate our ISV Partners' software with our hardware platforms, which could negatively impact our business and could hinder any future growth.

If we do not retain our senior management, we may not be able to successfully execute our business strategy.

Since our restructurings in fiscal 2001 and 2002, and as a result of our acquisition of TidalWire, we have added key members of our current management team. The loss of key members of our current management team could harm us. Our success is substantially dependent on the ability, experience and performance of our senior management team. Because of their ability and experience, we may not be able to successfully execute our business strategy if we were to lose one or more of these individuals. If we are unable to successfully execute our business strategy, our operating results would suffer.

Our stock may be subject to substantial price and volume fluctuations due to a number of factors, many of which will be beyond our control that may prevent our stockholders from reselling our common stock at a profit.

The securities markets have experienced significant price and volume fluctuations in the past and the market prices of the securities of technology companies have been especially volatile. This market volatility, as well as general economic, market or political conditions, could reduce the market price of our common stock in spite of our operating performance. In addition, our operating results could be below the expectations of public market analysts and investors, and in response, the market price of our common stock could decrease significantly. Investors may be unable to resell their shares of our common stock for a profit. In the past, companies that have experienced volatility in the market price of their stock have been the object of securities class action litigation. If we were the object of securities class action litigation, it could result in substantial costs and a diversion of management's attention and resources. The decline in the market price of our common stock and market conditions generally could adversely affect our ability to raise additional

capital, to complete future acquisitions of or investments in other businesses and to attract and retain qualified technical and sales and marketing personnel.

We have anti-takeover defenses that could delay or prevent an acquisition and could adversely affect the price of our common stock.

Our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and, without any further vote or action on the part of the stockholders, will have the authority to determine the price, rights, preferences, privileges and restrictions of the preferred stock. This preferred stock, if issued, might have preference over the rights of the holders of common stock and could adversely affect the price of our common stock. The issuance of this preferred stock may make it more difficult for a third party to acquire us or to acquire a majority of our outstanding voting stock. We currently have no plans to issue preferred stock.

In addition, provisions of our second amended and restated certificate of incorporation, second amended and restated by-laws and equity compensation plans may deter an unsolicited offer to purchase us. These provisions, coupled with the provisions of the Delaware General Corporation Law, may delay or impede a merger, tender offer or proxy contest involving us. For example, our Board of Directors is divided into three classes, only one of which is elected at each annual meeting. These factors may further delay or prevent a change of control of our business.

We may need additional capital that may not be available to us and, if raised, may dilute our existing investors' ownership interests.

We may need to raise additional funds to develop or enhance our services and solutions, to fund expansion, to respond to competitive pressures or to acquire complementary products, businesses or technologies. Additional financing may not be available on terms that are acceptable to us. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders would be reduced and these securities might have rights, preferences and privileges senior to those of our current stockholders. If adequate funds are not available on acceptable terms, our ability to fund expansion, take advantage of unanticipated opportunities, develop or enhance products or services, or otherwise respond to competitive pressures would be significantly limited.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not engage in any foreign currency hedging transactions and therefore, do not believe we are subject to material exchange rate risk. We are exposed to market risk related to changes in interest rates. We invest excess cash balances in cash equivalents and as a result, we believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations and cash flows will not be material. In addition, a hypothetical 10% increase or decrease in interest rates would not have a material adverse effect on our financial condition.

ITEM 4. CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's chief

executive officer and chief financial officer, evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of June 30, 2003. Based on this evaluation, the Company's chief executive officer and chief financial officer concluded that, as of June 30, 2003, the Company's disclosure controls and procedures were (1) designed to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the Company's chief executive officer and chief financial officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended June 30, 2003 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II--OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Initial Public Offering Lawsuit

On or about December 3, 2001, a putative class action lawsuit was filed in the United States District Court for the Southern District of New York against the Company, Lawrence A. Genovesi (the Company's Chairman and former Chief Executive Officer), Douglas G. Bryant (the Company's Chief Financial Officer and Vice President of Administration), and the following underwriters of our initial public offering: FleetBoston Robertson Stephens, Inc., Credit Suisse First Boston Corp., Goldman Sachs & Co., Lehman Brothers Inc. and Salomon Smith Barney, Inc. (collectively, the "Underwriter Defendants"). An amended class action complaint, captioned In re Network Engines, Inc. Initial Public Offering Securities Litigation, 01 Civ. 10894 (SAS), was filed on April 20, 2002.

The suit alleges that the defendants violated the federal securities laws by issuing and selling securities pursuant to the Company's initial public offering in July 2000 ("IPO") without disclosing to investors that the Underwriter Defendants had solicited and received excessive and undisclosed commissions from certain investors. The suit also alleges that the Underwriter Defendants entered into agreements with certain customers whereby the Underwriter Defendants agreed to allocate to those customers shares of the Company's Common Stock in the offering, in exchange for which the customers agreed to purchase additional shares of the Company's Common Stock in the aftermarket at pre-determined prices. The suit alleges that such tie-in arrangements were designed to and did maintain, distort and/or inflate the price of the Company's Common Stock in the aftermarket. The suit further alleges that the Underwriter Defendants received undisclosed and excessive brokerage commissions and that, as a consequence, the Underwriter Defendants successfully increased investor interest in the manipulated IPO securities and increased the Underwriter Defendants' individual and collective underwritings, compensation and revenues. The suit seeks damages and certification of a plaintiff class consisting of all persons who acquired

shares of Network Engines' common stock between July 13, 2000 and December 6, 2000.

In July 2002, the Company, Lawrence A. Genovesi and Douglas G. Bryant joined in an omnibus motion to dismiss challenging the legal sufficiency of plaintiffs' claims. The motion was filed on behalf of hundreds of issuer and individual defendants named in similar lawsuits. Plaintiffs opposed the motion, and the Court heard oral argument on the motion in November 2002. On February 19, 2003, the Court issued an opinion and order denying the motion as to the Company and the case may now proceed to discovery. In addition, in October 2002, Lawrence A. Genovesi and Douglas G. Bryant were dismissed from this case without prejudice. On July 9, 2003, a special committee of the Board of Directors has authorized the Company to negotiate a settlement of the pending claims substantially consistent with a memorandum of understanding negotiated among class plaintiffs, all issuer defendants and their insurers. Any such settlement would be subject to approval by the Court.

We are unable to predict the outcome of this suit and its ultimate effect, if any, on our financial condition; however, our defense against this suit could result in the expenditure of significant financial and managerial resources.

TidalWire Acquisition Lawsuit

A purported class action and derivative lawsuit was filed on January 7, 2003 in the Court of Chancery in the State of Delaware against the Company and certain members of its Board of Directors relating to the acquisition of TidalWire Inc. The plaintiffs in the complaint allege that the Company and the named directors of its Board of Directors breached their fiduciary duties by, among other things, paying an excessive amount in the acquisition of TidalWire and purportedly failing to disclose material facts in the Company's Joint Proxy Statement/Information Statement distributed to stockholders for approval of the issuance of shares of the Company's Common Stock in the merger. The plaintiffs are seeking damages, rescission of the merger and other relief. On June 18, 2003, the Court denied a motion to dismiss filed by the Company and the named members of its Board of Directors. The Company and the named members of its Board of Directors have since answered the complaint and the case is proceeding through discovery. The Company believes that it has highly meritorious defenses and intends to vigorously defend against the suit, but given the early stage of the proceedings, the Company cannot predict the ultimate outcome of the litigation. However, as of June 30, 2003, the Company has recorded a liability of $250,000 in connection with this litigation.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(d)Use of Proceeds from Sales of Registered Securities

On July 18, 2000, the Company sold 7,475,000 shares of common stock in an initial public offering at a price of $17.00 per share pursuant to a Registration Statement on Form S-1 (the "Registration Statement") (Registration No. 333-34286), which was declared effective by the Securities and Exchange Commission on July 12, 2000. The managing underwriters of the initial public

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offering were Donaldson, Lufkin & Jenrette, Dain Rauscher Wessels, Robertson

Stephens and DLJdirect Inc. The offering terminated upon the sale of all of the securities registered. The aggregate proceeds to the Company from the offering were approximately $116.9 million reflecting gross proceeds of $127.0 million net of underwriting fees of approximately $8.9 million and other offering costs of approximately $1.3 million.

During the period from the offering through June 30, 2003, the Company has used the proceeds as follows: approximately $56.8 million was used to fund the operations of the Company, approximately $5.2 million was used for the purchase of property and equipment, approximately $4.6 million was used to repurchase the Company's Common Stock under a stock repurchase plan and approximately $13.2 million for the Company's acquisition of TidalWire Inc. Of the $13.2 million of proceeds used to acquire TidalWire, $3,350,443 was paid to Ascent Venture Partners (together with its affiliated entities, "Ascent") and HarbourVest Partners (together with its affiliated entities, "HarbourVest"), two substantial stockholders of the Company. At the time of the acquisition, Ascent and HarbourVest owned approximately 18.1% and 16.3% of the outstanding common stock of the Company, respectively. Ascent and HarbourVest also owned 12.9% and 24.9% of the outstanding common stock of TidalWire, respectively. Pursuant to the terms of the merger agreement, the Company paid Ascent and HarbourVest $1,144,615 and $2,205,828, respectively, in exchange for their shares of TidalWire common stock. Furthermore, the proceeds paid to Ascent and HarbourVest may be deemed to be indirect payments to Frank M. Polestra and Robert M. Wadsworth, two of the Company's directors. As a managing member or general partner of each of the general partners that control Ascent, Mr. Polestra may be deemed to have indirectly received the $1,144,615 of proceeds paid to Ascent. As a managing director of the limited liability corporation that controls HarbourVest, Mr. Wadsworth may be deemed to have indirectly received the $2,205,828 of proceeds paid to HarbourVest.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the three months ended June 30, 2003.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

The exhibits which are filed with this report or which are incorporated by reference are set forth in the Exhibit Index hereto.

(b) Reports on Form 8-K

On April 24, 2003, we furnished a Current Report on Form 8-K under Item 9, containing a copy of our earnings release for the period ended March 31, 2003 (including financial statements) pursuant to Item 12 (Results of Operations and Financial Condition).

On May 1, 2003, we furnished a Current Report on Form 8-K under Item 9, containing an excerpt from the transcript from our second quarter 2003 results conference call and webcast held on April 24, 2003 pursuant to Item 12 (Results of Operations and Financial Condition).

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NETWORK ENGINES, INC.

Date: August 14, 2003

John H. Curtis

President and Chief Executive Officer

(Principal Executive Officer)

Douglas G. Bryant

Vice President of Finance and Administration,

Chief Financial Officer, Treasurer and Secretary

(Principal Financial Officer and Principal

Accounting Officer)

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EXHIBIT INDEX

Exhibit No.	Exhibit
31.1	Certification of John H. Curtis, President and Chief Executive Officer, pursuant to Rule 13a -14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Douglas G. Bryant, Vice President of Finance and Administration, Chief Financial Officer, Treasurer and Secretary, pursuant to Rule 13a -14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of John H. Curtis, President and Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Douglas G. Bryant, Vice President of Finance and Administration, Chief Financial Officer, Treasurer and Secretary, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.